RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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May 3, 1989 **LETTER 1016**

WE'RE OFF: The last time I left my ancient Royal typewriter (today I use a Macintosh computer) for more than five days running was back in 1957. The last time I was in Europe I was in a B-25 bomber bending over a Norden bombsight (in case you've forgotten that was during World War II).

People sometimes ask, "Russell, do you like Europe?" And I answer, "To be honest, last time I visited Europe I didn't like it too well, but one of these days I'm going to go back and take a second look." That day has arrived. So this month I'm going to return to Europe (Paris and London, anyway) to see what's happening and to see if it has changed much over the last 44 years.

When the War ended in 1945 my nerves were a bit frayed, and I made a vow which ran something like this, "I don't ever want to see Europe again. I don't ever want to see Africa again. I don't ever want to see a 50 calibre maching gun again, and if I ever go up in a plane again it will be too soon."

But time has mellowed me, and bullet-scarred buildings and German flak and kids begging in the back streets of Naples and planes with wings blown off are now just a bad memory. So on May 10 my wife, Faye, and I are off to Europe where I have many friends and where I hope to learn a lot -- and where I hope to do some good for my subscribers by way of first-hand information and observations.

There's one problem -- the Letters. I've been writing these Letters for 30 years straight, and I've never missed a single deadline. But this time I'm going to have to change the schedule a bit, so please bear with me. I'm going to mail a short Letter on May 12 (Letter 1017), and the next Letter will be mailed on May 31 (Letter 1018). That will give me breathing time and a chance to travel a bit and to (hopefully) broaden my mind.

THE PICTURE: On April 18 the D-J Industrial and Transportation Averages along with almost all the major averages broke out above their trading range (i.e., above their February 8 peaks), to close at new post-crash highs. The move was confirmed on a near-term basis by the advance-decline ratio which rallied to its highest level since last July (see page 2 chart).

The move came as no surprise to my Primary Trend Index (PTI), which had been advancing to new highs week after week (see page 2 chart). As this is written the PTI is at a new high and shows no signs of reversing to the downside. The trend of the PTI turned bullish in January 1988, and that trend has been in force for 15 consecutive months. The history of the PTI shows that it signals remarkably few trend changes (in other words, it is not given to whip-saws).

So the question is, what do we have here? What's the market doing and saying? Following are some of my thoughts and observations:

(1) On a strict interpretation, the Dow Theory notes that the Transportation Average on April 18 closed at a new all-time high, a high that was (and still is) unconfirmed by the Industrials. Thus, we now have a primary non-confirmation. In order to confirm the new Transport high, the Dow would have to rise to a new record high of its own -- above its 1987 bull market peak of 2722.42.

April 21 DJIA 2409.46; PTI 3002; A-D Ratio -9.09
April 28 DJIA 2418.80; PTI 3011; A-D Ratio -8.92
Current Dow Yield: 3.45; Dow P/E: 11.2
Dow Book Value: 1009; Dow 200-day MA: 2182
DowPow: 822
Percentage of undervalued blue-chips: 20%

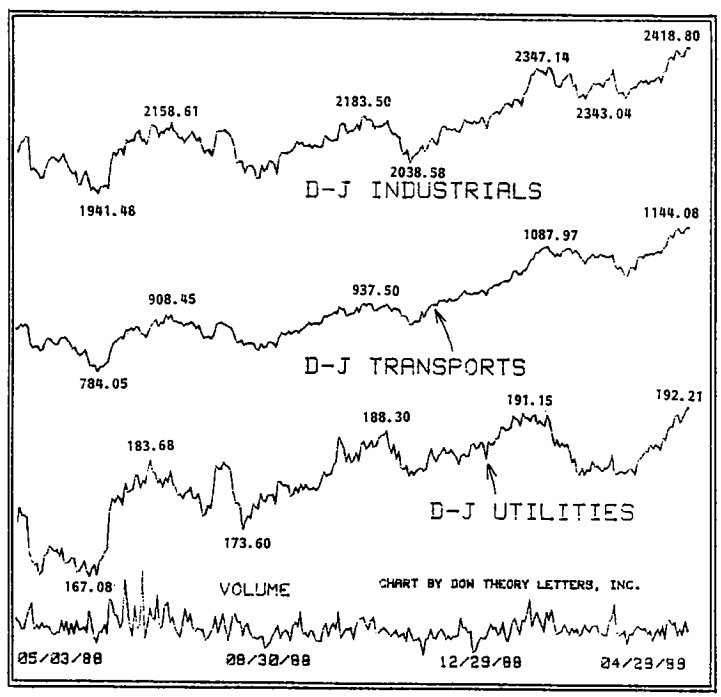
(2) With the Transports at record highs, the Dow is still roughly 300 points below its own August 1987 record high. This is the widest point spread for a non-confirmation that I have ever seen.

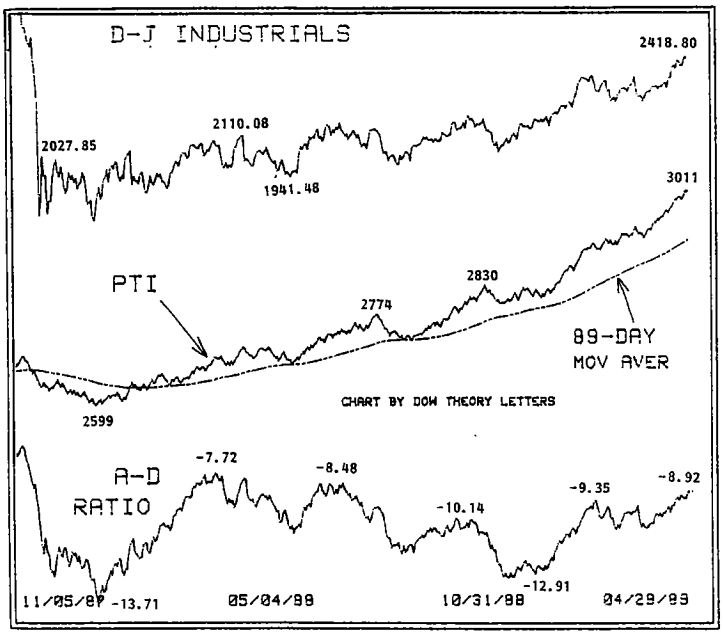
What this means is that it will be difficult for the Industrials to confirm. However, there is no time limit for a confirmation. The Industrials may confirm in a week or six months. But the closer (in time) a confirmation, the more authority the Dow Theory attaches to that confirmation. Conversely, the longer the interval between a new high in one Average and a failure to confirm by the other Average, the less appetizing the picture.

(3) Question -- is it possible that I mis-diagnosed (was wrong) in calling a bear market in October 1987? Or is it possible that a bear market started at the August 1987 highs and ended only three months later at the October 19, 1987 crash lows?

Market analysis isn't an exact science, and I don't have a direct line to the gods of the market. So I could have been wrong in calling for a major bear market beginning in late-1987 (although that bear market call did result in my subscribers avoiding a disastrous crash). But it will take a while before we can receive re-confirmation for the direction of the primary trend of the market.

As I have written many times, this whole period reminds me a good deal of 1966-74. During those difficult years the Dow ran up repeatedly towards the highs, then collapsed after each attack. In January 1973 the Dow actually rallied to a new all-time high (although at that time the Transports lagged badly and failed to confirm).





To compare 1973 with the current situation -- with the new Transport high recorded in April 1989, it could be that this time it will be the Industrials that refuse to confirm. Only time will tell.

(4) Question -- what happens if the Dow does confirm the Transports by rising to a new all-time high above 2722.42? If the Dow confirms by rising to a new record high I would probably take the position that (in retrospect) the 1987 crash was a freak occurrence in a continuing bull market, a bull market that had produced one of the most costly corrections (i.e., the crash) in stock market history. In that case, of course, I would have been wrong in labeling the primary trend as down.

(5) With it all, the fact remains that this has been (and still most definitely is) a high-risk area for stocks. With stock yields low (and particularly with stock yields low compared with short-term money rates) history says that the stock market is treading on thin ice. Of course "high risk" doesn't mean that stocks can't go higher. Stocks rallied all during the summer of 1987 right up to the August 25 peak prior to the crash -- and that whole area was high-risk as far as the background for common stocks was concerned.

"A PRISONER OF DEBT" (the Russell Opinion): Here's what I really believe is happening at this time.There's an old adage which states, "Owe a bank $100,000 and they own you. Owe a bank $100 million and you own the bank."

I think the Fed and the Administration are now prisoners of the "debt monster." To re-phrase the above adage, "When this nation was mildly in debt, the Federal Reserve Board and the Administration could call the tune for the markets. But today, with the nation over it's head in debt, it's the debt that runs the nation."

What this means is that the markets know only too well that the country is up to its neck in debt. Furthermore, the markets know that the Fed and the Congress and the Administration are terrified of doing anything that might bring on a recession, a recession that could very likely topple the US into a debt-crunching depression. So what's happening? The stock market is "making hay while the sun shines."

Consider the current situation. Crude oil prices have surged to over $20 a barrel, the Producer Price Index has pushed up 1% two months in a row (a 12% rate), the CPI is running at a 6% inflation rate, industrial materials prices have advanced to new highs, factory utilization is near capacity. In the face of all this, what's the Fed's position? A discount rate of a mere 7% plus ample free reserves in the banking system.

And despite this relatively easy position, President Bush tells Fed Chief Greenspan at every opportunity that he doesn't want rates pushed too high. On top of that, the Fed and the government have followed a policy of bailing out each and every industry that shows signs of going belly-up.

Conclusion: The US debt monster is now calling the tune, and the words and music are, "Easy, easy does it. Don't do a thing to upset the market, and if anyone's in trouble, keep 'em going, keep 'em floating, bail 'em out!" All this the market sees and understands. Therefore, as I see it, we're at an incredible juncture in America's financial history -- it's an era when the debt monster rules and runs the financial and economic world. And the markets are taking full advantage of the situation by running up as far as they can in the face of the Fed's virtual paralysis.

The ultimate result, I believe, will be the economy and the markets FORCING the government's hand. The force may come from overseas (for instance, Germany just raised its bank rate), or the force may come from the markets themselves. The first warning came from the markets on October 19, 1987. The second warning, I believe, lies somewhere ahead.

Question: Russell, if the PTI is doing such a good job in showing the way for the market, why not just drop everything else in your Letters, and simply concentrate on the trend of the PTI?

Answer: This is a question that I've been asked, and one that I've answered many times before. The above approach might work for a while, but no index, device or indicator is infallible. For instance, the PTI in October 1987 turned down and broke its moving average (thereby giving a bear signal) simultaneously with the bear market signal. But that PTI's bear signal couldn't tell us whether we were facing a mild decline of 75 Dow points or the worst crash in history.

During that same period my other studies indicated that the market was on extremely weak footing, and I told subscribers to exit the market well before the PTI bear signal on the basis of these other studies.

On the other hand, the PTI moved back above its moving average and thereby turned bullish in January 1988. Subscribers who followed the PTI and moved into the market strictly on the basis of the PTI signals have done well.

So the PTI can be extremely useful and profitable as a market tool, and 90% of the time you will be making money by investing or trading strictly on the basis of the PTI. But unfortunately, the PTI can't tell you the whole story. And obviously the PTI, useful as it is, can't predict a crash.

Of the 30 Dow Industrial stocks, 13 are now clearly bullish on a trend (i.e., above their moving average) and relative strength basis. These 13 are Aluminum Co.; Amer. Express; Amer. Tel.; Beth. Steel; Boeing; Coca Cola; Int. Paper; McDonalds; Merck; Philip Morris; Texaco; Union Carbide.

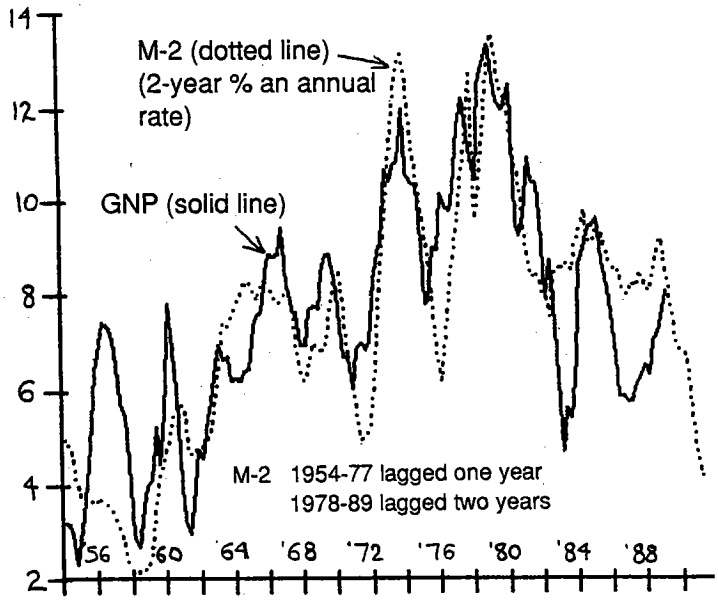
INVESTMENT POSITION: It doesn't jibe with the bullish trend of my PTI, but according to classic Dow Theory the bull still belongs in the box.

The following is from the Merrill Lynch new *Spring Quarterly* : "The saver is winning the battle, collecting and reinvesting bond yields which not only exceed the rise in GNP or income growth, but rival the long-term returns historically available from equities. Investors are aware of the risk of higher interest rates in the short run -- booming money market fund inflows and lines outside the Fed to particpate in T-bill auctions. The greater risk, it seems to us,

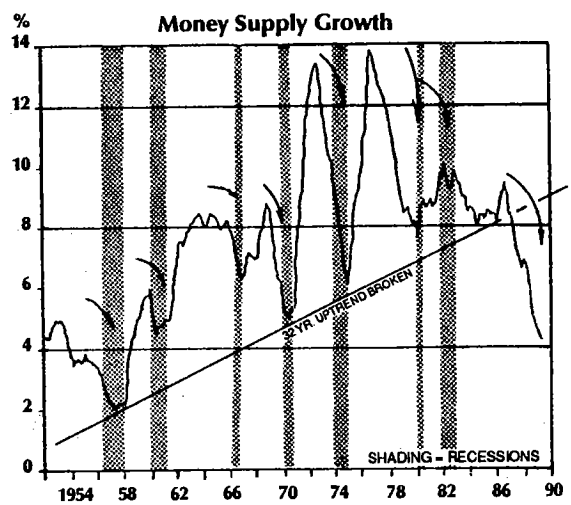
is that of losing the war if current yields are not locked in. Only once in the history of the Republic, during the late 1970s and early 1980s, when inflation was sustained at double-digit levels, were long Treasury yields sustained above 9.5%."

I don't disagree with this analysis. Over recent weeks bonds have rallied strongly, and many of those juicy note and bond yields have disappeared. The munis have been particularly strong, with the June muni contract breaking out last week to a new high for 1988-89. Those who are buying or holding stocks have the trend of the rising PTI to justify their position. For conservative investors, when safety and return on the investment is considered, the two-year T-notes are hard to beat.

MONEY, MONEY: There's something very different about this stock market rise. And it has to do with money. I am including two charts with this section. The first is courtesy of Ed Hyman and C.J. Lawrence. It shows (dotted line) the annual rate of the broad M-2 money supply on a two-year percentage change. Note that plotted this way, the rate of change in M-2 produces an extraordinarily good fit with the actual Gross National Product of the US. In other words, the long-term change in M-2 most definitely affects the nation's GNP. As you can see on the chart, the rate of change in M-2 has recently plunged.



The second chart (courtesy of *Aden Analysis*) shows the same two-year growth rate in M-2, but here we also see that the growth rate of M-2 has plunged below a 32-year rising trendline. In other words, what we're seeing now is a drastic decline in the growth rate of the M-2 money supply. The shaded vertical stripes on the chart depict areas of recession. Note that in the past, whenever the M-2 growth rate plunged, it was followed by recession.



So the question now is -- has this relationship of the growth rate of M-2 and GNP ended? If it has, then we are witnessing something new. If it hasn't changed, then we are facing recession ahead.

If something has changed, what could that change be? The only thing I can think of is that today we have moved into a global situation. There's no question about it, huge hoards of money are coming to the US from abroad. This money is buying up banks, real estate, stocks, bonds and corporations. Could it be that this torrent of foreign money and investments has upset the M-2/GNP relationship? That could explain why the plunge in the growth rate of M-2 has not (at least, so far) sunk the economy into recession.

The second possibility is (as seen on the first chart) that the US is right on the edge of recession. With housing and auto sales weak, with retail sales leveling off, it could be that the nation is about to sink into recession, but it just hasn't happened -- yet.

A third possiblity is that the market sees recession, but the market believes it will be a very mild recession, so mild, in fact, that Wall Street has decided to jump over the recession-canyon.

Of course there's a fourth possibility. And that possibility (although I'm skeptical about this one) is that the stock market is going to be just plain wrong. In other words, a recession is coming but the stock market either doesn't see it or doesn't believe it. That would mean that the market is heading for a shock and a surprise. I must add, however, that instances in which the market is surprised are few and far between.

In all, it's a fascinating picture and one that at the moment remains murky and mysterious.

QUESTIONS and ANSWERS. Question: Russell, I want to start a market letter of my own. You've been in this for business 30 years, almost longer than anyone else. Your's is a business that seems to knock out half of its participants every year. So what's the secret of success and longevity in advisory publishing?

Answer: I don't know if there is any secret, but here's what I believe has helped me. First, I love to write (when I got out of college I was intent on writing "the great American novel," but I soon found out that truth is more exciting and much more interesting than fiction). Second, I love the markets. I've always been obsessed with trying to unravel the mystery of what the markets are saying.

Third, I try to relate to my readers. We have every conceivable kind of subscriber on the books -- from Arab bankers to American billionaires to mutual fund managers to widows from Brooklyn to farmers from South Dakota. In fact, I'm constantly amazed at the wide differences and backgrounds of my subscribers. But I believe that ALL subscribers are interested in trying to understand what is happening in the markets and in turning that knowledge into profits.

I believe I'm interested in the same things my subscribers are interested in, and that rules my writing. When I finish one of these Letters I always ask myself one question -- "When readers put this Letter down, are they going to know more than when they picked it up?" In other words, was reading this Letter worth the subscriber's valuable time? If the answer is yes, then the Letter was a success by my standards.

Next, I'm a conservative. My mottos are: (1) above all, don't lose money; (and two corollaries) (2) safety of principle is imperative, and (3) if you don't lose money, you're almost sure to make it.

I find that the great majority of my subscribers appreciate that approach. I also advocate that each person adopt a system or strategy that he or she can live with -- and then stick with that strategy. In other words, don't be blown north or south with every Wall Street rumor. Stick to your system. If it makes sense, you'll make money with it.

I'm a great believer in compounding. Compounding is the guaranteed road to riches. Very few advisories talk about compounding. I never stop talking about it. I'm of the opinion that the best investment book ever written was "The Compound Interest Tables."

I try to tell a story in these Letters. To me, there is nothing more exciting, more dramatic, than Wall Street and the markets. It's a story that encompasses everything from the price of oil in Texas to the struggles of the US to compete in the new global economy, from the lies that Washington tells about the budget to the next earnings report out of IBM.

Finally, I try to keep my ego out of this business. I do the best I can, I tell the story as I see it -- that's what I offer, and that's all I offer. If you mix your ego with your market analysis, if you try to obtain your sense of worth from your market writings, you're on the road to destruction in this business. The market has a diabolic habit of searching out your worst weakness and trying to destroy you with that weakness. So if your ego demands that you be a market "guru," watch out. The history of the advisory business is that the market destroys gurus as fast as they move into the limelight.

Every day millions of man-hours go into analyzing and deciphering the markets. It's a never-ending struggle, and it's a struggle that can make you a billionaire or a pauper. It's a battle that can pit a Mike Milken against the power of the government or it can pit a Ross Perot against a giant like GM.

In other words, I love the business, and I'm fascinated with the business, and I hope that somehow that comes across to subscribers. I don't know what else to say about my longevity in this very difficult business.

Question: The world appears to be in a "new peace mode." How do you think this will affect the global economies"?

Answer: For years I have been saying that Russia is in a terrible bind. The struggle for world power has switched from military power to economic power, and Russia's economy has become a pathetic, unworkable laughing stock. One major problem for Russia (but certainly not the only one) is the disproportionate amount of money the Soviets have squandered on their massive military establishment. Gorbachev recognized his nation had to opt for computers, real production, and a move into the 20th century. This means that the Soviets must reduce their military -- or sink to the status of a second- or even third-class nation. Gorbachev saw that the Soviet military had become a ridiculous drain -- and that the battles of the future were to be in the economic area rather than the military.

This kind of thinking, I believe, has rubbed off on most of the nations in the world (even including Libya and Iran). The future belongs to the producers, not the warriors. The armaments business is a trillion dollar a year business. And the massive production of weapons has been reponsible for hundreds of billions in deficits in the US and in many other countries.

If the "peace push" actually results in a major decline in weapons production, it will be a boon for humanity. It will also cause major dislocations in many economies.

Question: The US has enjoyed seven consecutive prosperous years, a record. Now some economists (for instance, Jude Winniski) are saying that due to increased knowledge and Fed fine-tuning, recessions may be a thing of the past. Do you agree?

Answer: Bull and bear markets (and recessions and booms) are a function of human nature. When good times are here and as they continue, people become optimistic, then enthusiastic, and finally frenzied. When that happens people tend to do foolish things, like taking on too much debt. Eventually, the speculative edifice topples of its own weight. Recessions and bear markets are the aftermath.

Of course, the same process (in reverse) occurs on the downside. If you could change human nature, if you could eliminate the urge to speculate, if you could outlaw greed and the urge to become wealthy, then you could probably end the business cycle. But I don't know of any nation that has ever outlawed characteristics that seem to be built into mankind's psyche.

Question: Can the Fed control the money markets?

Answer: I don't think so. Many years ago the bill market traded with a volume of around $7-10 billion a day, and the Fed, with its open-market operations of a few billion, could control that market. But today the bill market trades $50 to $100 billion a day. That's too big a market for the Fed to manipulate for very long.

The same thing goes for the dollar. The central bankers work with maybe $5-8 billion, trying to control a market that trades $750-1,000 billion a day. The banks can manipulate this market for a day or so, but during a major or tidal movement the banks would be helpless.

No, the currency and debt markets now dwarf the manipulative capabilities of the US's and the world's central bankers. Yesterday's rivers of currency and debt instruments have become today's currency and debt oceans.

NOTES & QUOTES: On March 19 the price of crude oil jumped over one dollar to the mid-24 level. That's a 85% rise from last October's low of around $13 a barrel. One-third of the US trade imbalance is due to oil imports, and the 85% price boost isn't going to help at all. At $25 a barrel it pays domestic sources to starts looking for oil again. But meanwhile, US oil prodiuction is at its lowest level since the 1960s. Therefore, look for OPEC to hold oil under 25. OPEC doesn't want competition. Also look for inflation to heat up -- maybe to double digits. The price of oil cuts across a huge area of the US economy from chemicals to fuels to fertilizers.

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The federal budget figures have become a national disgrace, and the newspapers are finally picking it up (I've been writing about this for years). On April 24 the *New York Times* included this piece in which Charles Boswher, Comptroller General of the US (he heads the General Accounting Office) states, "We are adding $1 trillion every five years to the total deficit and are digging a huge hole that will be very hard to get out of. The budget deficit is growing exactly the way the S&L crisis grew. I think you've got to reform the whole budget process. Everyone knows the numbers are fudged, and they never reflect reality, because often enough the revenue is exaggerated and the spending is underestimated." Russell Comment: And this from the Comptroller General ! !

No. 1 Whistle Blower Derides Deficit Figures

By NATHANIEL C. NASH
Special to The New York Times

WASHINGTON April 23 —

Bush-Democrat budget is a fraud

WASHINGTON — Let's not beat around the Bush: The administration's deal on the budget with Demo- ... leaders is a fraud. It presumes to ... pens those things offset each other from a deficit standpoint."

That is misleading, and Darman shouldn't be allow- ... of all the offset he men- ... and undercapacity in the computer systems of the New York Stock Ex- ... change ...

A Doomed Deal on the Deficit

By Hobart Rowen

Let's not beat around the bush: The administration's deal on the budget with Democratic congressional leaders is a fraud. It presumes to meet the budget-reduction requirements of the Gramm-Rudman-Hollings law with a slew of gimmicks and a tainted economic forecast. The implied promise is that higher than forecast. And it so happens those things each other from a deficit standpoint."

That is misleading. The offset he mentions mig be exact; it might not even occur in the same year. Moreover, higher interest rates can trigg only inflation but also a recession that would r

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Federal "off-budget" financing has become part of the multi-billion dollar budget scam. The latest outrage -- when the Post Office was in surplus it was put on budget (in 1985). This year the PO is losing money so it was taken off-budget again. The current game

has to do with getting around Gramm-Rudman's rubbery rules. Note: the Chairman of the House Banking Committee now estimates that the total cost of the S&L bailout over 30 years (including interest) will be $335 billion. That's right, one-third of a trillion dollars!

Interest on the federal debt for the single month of March alone was $16.5 billion. For this fiscal year, so far, the interest on the debt was $117 billion. That's up 11.2% from a year earlier. The nation is literally being eaten up alive by debt and interest costs. And interest rates reflect it. Ponder this: in the 199 years since 1790, there have only been 19 years when rates on quality bonds were above 8%. All of those "above 8%" years were times of high inflation or political or social upheavals.

* *

A private pool is the ultimate class-status symbol in status-happy New York. Alas, there are only six apartments and nine townhouses in the entire city with their own private pools. But cheer up, a few are for sale. There's a penthouse with pool at the Galleria on East 57 St. for $19 million. There's Khashoggi's triplex with pool on Fifth Avenue for $49 million. There's a three-trerrace three bedroom apartment with pool at Le Triomphe for a low $17,000 a month rent. Finally there's a pool at the Dakota (I used to play in their yard when I was a kid), but this one is rumored to be more of a big bathtub than a pool.

* *

What's the fastest rising prison population in the nation? Answer: women. Probable reason -- drugs. When their boyfriends get arrested for drugs, the girlfriends often takes over the business, and in due time they get busted. Also, judges who used to take a paternalistic attitude towards addicted women are now becoming much more punitive.

* *

All the upside action on Wall Street has failed to rub off on the brokerage houses, which are now suffering a depression of their own. Drexel Burnham has just dropped its entire retail operation. Merrill Lynch announces that its first quarter profits dropped 45%. Paine Webber saw its income decline 41% in 1988. Since the crash, Shearson Lehman's retail sales have fallen in half --no thanks to their buyout of Hutton. (Item: Shearson is now the only major securities firm which, at the end of 1988, had no tangible net worth).

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The NYSE announced that in March program trading accounted for 11.1% of all Exchange volume, up from 9.1% in February. So what we're seeing on the various exchanges is basically institutional buying (a lot of program trading) and foreign transactions along with a generous sprinkling of domestic leveraged buyouts and takeovers.

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Progress report: the statistics for recipients of Aid to Families with Dependent Children (AFDC) makes interesting reading. During 1937-38 The percentage of AFDC children with "father not married to mother" was 2.8%. In 1961 the percentage rose to 18.2%. In 1975 the percentage climbed to 31.0%. By 1986 the percentage of the kids with "father not married to mother" zoomed to 48.9%. I don't have the 1989 statistics -- which is probably just as well.

* *

At a time when Americans are beginning to save more, the S&Ls are losing savings. Since the first of the years, the S&Ls have lost over $20 billion in deposits. During the same period, money market funds (which are much more sensitive to interest rate changes) have grown by $30 billion to a fantastic total of $356 billion. The inability of the S&Ls to attract money is causing seasoned observers to believe that the whole government bailout program for the S&Ls is a loser. Said Bert Ely, president of Ely & Co. (consultants to the industry), "I think [the effort to save the industry] is a mistake. It's like trying to save the family farm. All we can do is prolong the agony and raise the cost of cleaning it up."

* *

Facts & Figures: I don't know what it means (if it means anything), but a little known fact is that the Oliver North jury is all black (nine men, three women). . . . The wife of former US Attorney Rudi Giuliani was mugged on April 20 on East 89th St. in Manhattan. . . . State with the highest per capita income -- Connecticut at $22,761, New Jersey second and Mass. third. At bottom was Miss. with $10,992 and W. Va. $11,658. . . . This year average salaries plus bonuses of chief execs went over $1 million for the first time. Top man was Michael Eisner of Disney at $40.1 million, second "Frank Wells of Disney at $32.1 million, third Ed Horrigan of RJR Nabisco at $21.7 million, next F. Ross Johnson of RJR at $21.7 million. . . . Dealer Graff paid record prices per carat for diamonds at the Christie auction -- $408,064 per carat for a 3.14 carat pink diamond, $296,454 per carat for a 7.05 carat blue diamond.

* *

The Russian ruble (a non-convertible "junk currency") is worth $1.63 according to the Soviet government. But the black market tells us the real value; the ruble has slipped from a black-market value of 20 cents a few years ago to a current value of 6 cents. With a huge hoard of rubles ($78 billion worth) and very few products to buy, Russian consumers (in the face of rising inflation) are in a frenzy to purchase anything rather than hold their rubles (which are rumored to be devalued soon).

* *

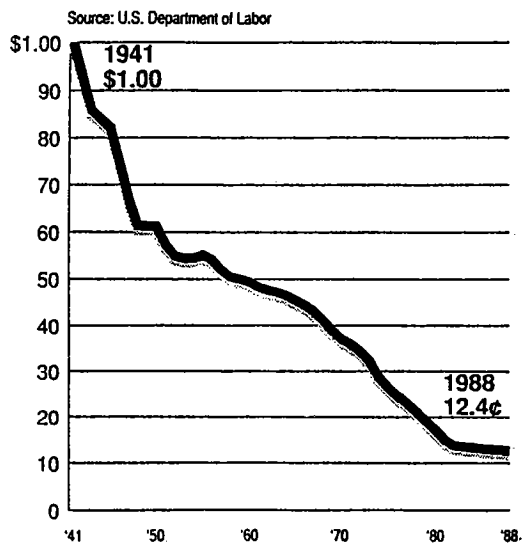
Old-timers gasped at No. 1 draft choice Troy Aikman's contract with Dallas -- $11.2 million for six years. The pay trend is sky-high for top footballers. Coming up are two new concepts -- international football and spring football. The NFL (under Tex Schramm) is organizing a 12-team international football league, so you can look for an increasing number of foreign names on the pro gridiron. Suggested foreign team names: the Brussel Sprouts, the German Forty-Rhiners, the Madrid Bulls. Football could soon rival soccer as a truly international sport. . . . Here's a figure worth pondering: the average salary for the LA Dodgers is $800,000 per man.

* *

Who's the top copyright pirate of the world? China. The international Intellectual Property Alliance reported that 12 nations headed by China were responsible for the US losing over $1.3 billion in foreign earnings from piracy of records, books, software, computers, and films.

* *

What's the saddest chart of the year? It could be a chart of the growth of crime in the US, but here's this week's candidate. It's another kind of crime -- the theft of the purchasing power of the dollar. You see, when we talk about America's high standard of living we don't usually talk about how we sustain that high standard. It's sustained by borrowing. The catch is that when you consume more than you produce, and you borrow the difference year after year, you have two choices. You either go broke or you inflate. Since a government that prints its own money never goes broke, it invariably choses inflation instead. When you inflate your money, however, you lose your purchasing power (which is the slow way of going broke). And that's where we are now.



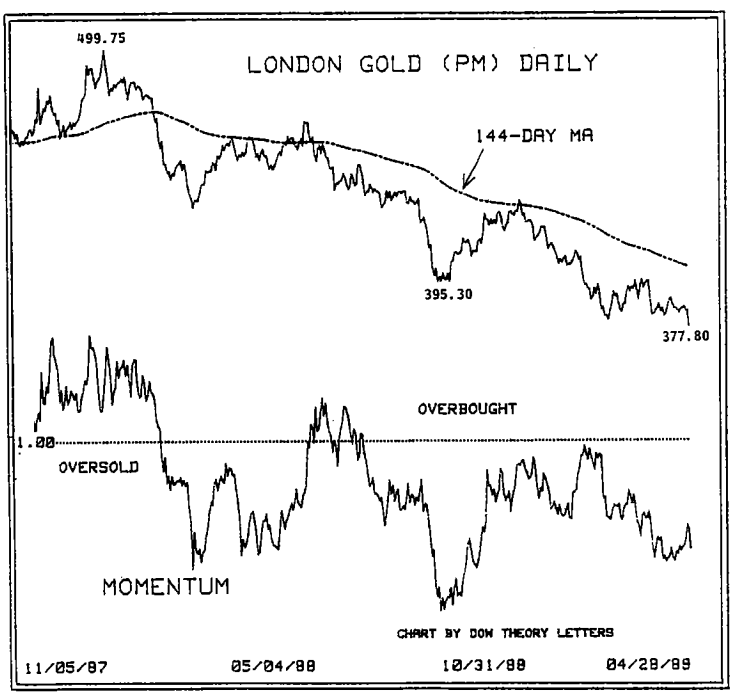
Do you remember the 5¢ hot dog? Do you remember a two-bedroom apartment off Park Avenue in NYC for $125? Do you remember a first-run movie for 35¢? Do you remember Broadway shows (matinee) for $1.10? Do you remember a five-course dinner for $1.90? Well I do. And that tells you a bit about what's happened to the dollar. That all happened when the federal debt was relatively small. Now with the debt pushing $3 trillion and annual deficits pushing $300 billion, you have to wonder about the buck's future (for more, read the gold section).

WHY OWN GOLD? Back in the 1950s I corresponded with Bernard Baruch, the great financier. In one letter Baruch wrote that his major worry for the future of the US was inflation. At that time I paid little attention to Baruch's warning -- but as usual Baruch was correct, very correct.

Recently a subscriber was kind enough to send me a few pages from the book, "Bernard Baruch, Park Bench Statesman." (Baruch would often hold court from a bench in New York's Central Park, and I often saw him sitting there in his charcoal-grey overcoat, enjoying the morning sun.) Here are a few passages from the book:

"Baruch liked gold mines. There is always a market, he pointed out, for their product, and at a satisfactory price. Gold, he insisted, is one of the very few things in the world that approaches the status of a permanent investment. Baruch told the story of a Rothschild who set up a 'permanent trust' consisting of five different currencies. By the time Baruch heard about the trust, it had shrunk to one-fifth its original value. 'But gold doesn't yield any interest,' a friend protested after listening to the story. 'True,' replied Baruch, 'but consider the fabulous wealth of some of the Indian princes and rajahs. I had dinner with the Maharajah of Kapurthala on one occasion in Vittel, France. Several of us talked afterward about his wealth, and someone said that among the treasures of these Indian moguls were gold coins brought to the East by Alexander the Great, hundreds of years before Christ.'

"'Their gold and jewels had earned no interest during these more than 2,000 years, but they still had their capital. Suppose they had attempted to provide income from it. They might have been no more far-seeing than the Rothschild I mentioned. If they had tried speculation there have been many times in each century that they might have gone broke. No, save for gold, jewels, works of art, perhaps good agricultural land, and a very few other things, there ain't no such animal as a permanent investment.'



"Even in agricultural land, Baruch pointed out, there is some risk. Lands that made men rich in rice cultivation years ago in Baruch's own state of South Carolina, are not nearly so valuable now that rice is produced more economically in other sections. City real estate is subject to all sorts of hazards, as he learned when he no longer needed his big Fifth Avenue mansion."

Thus spoke one of the great figures in American investing, an advisor to many presidents, a true guru.

The accompanying chart shows daily gold, and here we see the metal breaking to a new multi-year low. The moving average for gold is now 400, and that's the level above which gold must move to turn bullish again. For those who are buying a fixed-dollar amount of gold each month, the current price means that you can now buy most of the popular bullion coins at or a bit below $400. Don't worry about the coins going out of style. They'll be real money long after the dollar is a museum curiosity.

LATE NOTES: All the averages and indicators are "in gear" on the upside -- except for the big one. The big one I am referring to is the primary non-confirmation between the Transports and the Dow. As explained earlier, the Transports have risen to a new all-time high, but the Dow is still 300 points under its own record high of 2722.42. I might add that I have never seen such a wide spread in a major non-confirmation before.

The yield on the Transportation Average is now 1.53%, the lowest Transport yield ever during an era of rising earnings. So while the Dow is selling at a pricey 28.9 times dividends, the Transports are selling at an extraordinary and dangerous 65 times dividends.

The PTI continues to hit new highs (see chart page 2), while DowPow remains sluggish and stuck in its trading range. The lagging DowPow is a reflection of the dearth of big upside days in breadth (for instance, during March and April there were only two days which produced advances of 1,000 or more on the NYSE).

The interest rate picture is rather fascinating at this juncture. Germany (having been wiped out by inflation after the first World War) has as much fear of inflation as the US does of deflation (remember, the US was all but wiped out by deflation during the 1930's). The German wholesale price index recently rose to around 7% and consequently Germany boosted its bank rate. The Japanese bank rate is still at a low 2.5%, but in the face of rate competiton, particularly from the US, the dollar has strengthened against the Yen. This makes Japan unhappy since a strong dollar cuts into Japan's exports, and the question now is whether Japan dare raise her own bank rate.

A rise in Japanese interest rates would spell danger to the Japanese stock market, a market that sells at practically a zero yield. But more important, the Japanese financial and real estate markets are very highly leveraged and rising rates are the last thing those markets want.

LATE PERSONAL NOTES: I forgot to say that Faye and I are taking the Concorde from NYC to Paris and the same from London back to NYC (flight time less than 3 1/2 hours each way) . The Concorde flies at Mach 2 (twice the speed of sound) and in flight its outer skin grow rather hot due to friction, so hot, in fact that the plane actually expands 12 inches in length while in flight (I trust Faye and I will remain the same size). When we travel one of my main worries is finding low-fat food. My normal breakfast is a bowl of hot oat bran (which I really like), but I doubt whether Paris or London restaurants are into that sort of thing. Faye tells me that when she was in Paris seven years ago she practically lived on the delicous, no-preservative, low-calorie French bread. I ask traveling friends whether there are any salad bars in Paris or London, and they give me a sort of pitying, are-you-crazy look. But I'll survive.

NOTE CHANGE IN
NEXT MAILING: Friday, May 12